COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF PUBLIC UTILITIES

Investigation Commencing a Notice of Inquiry/Rulemaking for Electric Industry Restructuring Proceedings	D.P.U. 96-100

INITIAL COMMENTS

OF

INTERCONTINENTAL ENERGY CORPORATION

ON THE

DEPARTMENT'S PROPOSED RULES FOR ELECTRIC INDUSTRY

RESTRUCTURING

AND

REQUEST TO PRESENT TESTIMONY

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Intercontinental Energy Corporation ("IEC") submits the following initial comments concerning the Department's proposed rules governing electric industry restructuring announced on May 1, 1996 (the "Proposed Rules"). IEC presents these comments from its perspective as the owner and operator, through its affiliate Northeast Energy Associates, of a 300-megawatt cogeneration plant located in Bellingham, Massachusetts. Northeast Energy sells power under long-term contracts to Boston Edison Company, Commonwealth Electric Company and Montaup Electric Company, an affiliate of Eastern Edison Company. Under § 11.01(2) of the Proposed Rules, all of the aforementioned entities are likely to be affected by (if not directly subject to) the Proposed Rules, and thus IEC has a vital interest in the outcome of the current proceeding.

IEC applauds the Department for announcing generic rules. Together with recently announced Orders Nos. 888 and 889 of the Federal Energy Regulatory Commission ("FERC"), the Proposed Rules focus the ongoing public discussion and at the same time introduce creative concepts for further comment. IEC particularly favors (1) an independent system operator that is independent of those who would transact business within the restructured electric power market; (2) a regional, zoned network transmission tariff; (3) the functional separation of electric companies into distinct entities with appropriate rules governing

inter-affiliate transactions[1]; (4) protections to insure that electricity is available and affordable to all customers; (5) mechanisms to provide a reasonable opportunity for stranded cost recovery and protect municipalities from loss of electric company property taxes associated with diminished generation plant values; (6) protection of the environment; (7) promotion of energy efficiency and renewable resources; (8) encouragement of municipal electric companies to participate in the restructured industry; (9) a price cap system of performance-based regulation; and (10) a competitive generation market. IEC hopes that the Department will use the continuing proceedings in D.P.U. 96-100 to move ahead to improve upon the Proposed Rules, consistent with these ten principles.

REQUEST TO PRESENT TESTIMONY

IEC requests an opportunity to present oral testimony before the Department during its hearings on the Proposed Rules scheduled for June and July 1996.

[1] IEC is still studying whether mandatory separation of electric companies into distinct corporate entities may create unnecessary jurisdictional problems (particularly with respect to FERC) as well as unintentionally reduce the creditworthiness of the utilities. IEC reserves the right to address those issues in later testimony or written comments.

COMMENTS ON PROPOSED RULES

I. THE PROPOSED RULES DO NOT GUARANTEE THAT THE GENERATION MARKET WILL BE FUNCTIONAL AND EFFICIENT BY JANUARY 1, 1998

A properly functioning generation market is important to IEC. Although it is contractually committed to selling most of the power generated by its Bellingham plant to its current utility customers, IEC nevertheless has a vital interest in the shape of the generation market during the next decade. There are at least two reasons for this interest. First, the ground rules that are established in the upcoming years will have a great influence on the market that will exist when the Bellingham power purchase agreements expire, freeing IEC to compete with other power generating companies. As a future competitor, IEC necessarily wishes to see that the market operates smoothly and efficiently, now and into the future.

IEC's second and greater interest in an efficient generation market relates to the mitigation of stranded costs that may be associated with power purchase agreements. An efficient generation market is the precondition to commercially reasonable mitigation of any stranded costs associated with existing power purchase agreements. Independent power producers such as IEC are unlikely to be able to renegotiate their existing power purchase agreements voluntarily and on a "win-win" basis unless they can expect to compete in an efficient market to sell their power. If the Massachusetts wholesale and retail generation markets are fully deregulated before all of the key elements of an efficient

generation market (described below) are in place, Massachusetts generators will not have a fair opportunity to compete against power supplied at artificially low prices. Such power is likely to strand even more of the costs associated with power generated within Massachusetts in the following manner: cheaper power coming into Massachusetts would set a lower market "benchmark" against which stranded costs would be measured; Massachusetts competitors would be unable to turn to other markets to sell their "over-market" power. What Massachusetts ratepayers would gain in cheaper (and often dirtier) power would be lost in higher stranded cost charges.

For these reasons, IEC proposes that retail choice not begin until at least the following four preconditions for creation of an efficient generation market are met:[2]

Establishment of an Independent System Operator. This ISO must have the minimum responsibilities described at pages 15-16 of the Department's commentary on the Proposed Rules, with only those dispatch powers necessary for maintaining system reliability as determined by the ISO.

Promulgation of Effective and Fair Open Access Tariffs. While FERC Orders Nos. 888 and 889 have significantly advanced the prospects of fair, non-discriminatory provision of transmission services, the Orders by themselves do not provide such services. True open access depends on the utilities'

[2] Alternative regulations that embody these principles are found in Appendix A to these comments.

filing -- both as individual companies and as members of power pools -- of fair, non-discriminatory open access tariffs pursuant to the Orders, and FERC's approval of those tariffs. A true competitive market for generation will not exist until such tariffs become effective.[3]

Market Power. At pages 25-31 of its comments to the Proposed Rules, the Department expressed concerns about vertical and horizontal market power and its effect upon the nascent generation market. IEC shares these concerns, and proposes that prior to the commencement of retail choice, the Department complete an investigation into whether horizontal and/or vertical market power exists in the relevant product markets in which Massachusetts suppliers and consumers of generation services will operate, and whether the exercise of such market power is likely to harm competition were retail choice to begin. If the Department finds that such market power exists and that it is impeding competition, retail choice should be further delayed until the Department has taken all actions necessary to eliminate such effects.

Environmental Comparability. Without a requirement that all generators operate according to comparable, modern emissions standards, certain generators that are subject to less stringent environmental standards will have an undue advantage in the competitive generation market. To create a more level playing

[3] IEC recognizes that Orders Nos. 888 and 889 contemplate the filing of tariffs that should become effective before this Department issues its final rules in this proceeding. IEC nevertheless believes that the Department should make promulgation of fair, non-discriminatory open access tariffs a precondition for retail competition in the event that the effective date for such tariffs is delayed for any reason.

field, the Department should tie recovery of stranded costs to the application of modern emissions standards, as proposed in part (III) below.

II. THE DEPARTMENT'S STRANDED COST RULES MAY ELIMINATE THE PROSPECTS FOR NEAR-TERM RATE RELIEF

At page 8 of its comments accompanying the Proposed Rules, the Department states that its comments as well as the Rules reflect the Department's "continuing support" for its seven final and five transitional restructuring principles announced in D.P.U. 95-30. One of the Department's transitional principles -- and an earnest desire of all Massachusetts ratepayers -- is near-term rate relief. The Proposed Rules, however, do not explicitly state how the Department anticipates providing such relief. For example, in the Department's March 15, 1996 procedural ruling, the Department required each electric utility to file "revenue-neutral" unbundled rates by October 7, 1996, to be effective no later than March 31, 1997. By definition, "revenue-neutral" unbundled rates are unlikely to result in rate relief by themselves. [4] Moreover, as restructuring progresses, the Department will necessarily lose its control over the prices of the present "bundle" of electrical services: FERC will play the dominant role in regulating the price of transmission services, and generation prices will be set by the market. Although competitive forces should make power less expensive over time, no one knows how quickly prices will decline. As for the price of distribution services, the application of performance-based rate

[4] The Department suggests at page 52 of its comments accompanying the Proposed Rules that publication of a regional index for projecting the hourly price of energy one day in advance, as well as a calculation of actual hourly prices after the fact, "may provide an opportunity for some customers to...achieve actual savings in 1997." Given present metering and information limitations, it is likely that only a handful of Massachusetts customers will be able to realize such savings in the near future.

regulation should foster rate relief, but its effects too are most likely to be felt only in the long run.

Most likely, there will be only one component of the future customer's bill over which the Department will have sufficient control in the short term to obtain some level of near-term rate relief: the Stranded Cost Access Charge. As proposed, however, the Department's stranded cost rules cannot produce short-term customer savings while simultaneously affording the electric utilities a reasonable opportunity to recover their stranded costs. The key limitation in this regard is the Department's insistence on recovering stranded cost charges that may be associated with commitments like the Bellingham power purchase agreements, which have a term far longer than ten years, in a compressed period of ten years. By thus compressing the recovery period, the Department requires the utilities to "front load" their recovery of stranded costs, effectively eliminating any flexibility the Department might have to provide near-term rate relief.[5]

The Department's Proposed §§ 11.03(2) and (3)(a)(ii) classify the potential sources of stranded costs into four categories: (a) costs related to generating facilities that are

[5] The effect of such compression on the likely stranded cost access charge, and in turn, customer rates, is not well known. During hearings, IEC requests that the Department ask all of the investor-owned utilities within its jurisdiction to provide an analysis of the likely stranded costs and related access charges assuming, first, a ten-year recovery period, and second, recovery over the depreciable life of the stranded asset and/or term of each contract giving rise to a stranded cost.

wholly or partly owned by utilities; (b) book costs associated with regulatory assets; (c) costs that will be required to decommission nuclear generating facilities; and (d) minimum financial obligations of utilities under existing long-term power purchase contracts. Proposed § 11.03(3)(a)(v)(4) ties the period for recovery of nuclear decommissioning costs to the expiration date of the operating license of the affected nuclear facility. Power purchase agreements should be treated in the same way, for at least four reasons:

- Unlike utility generating assets, which in many cases are at or near the end of their depreciable lives, virtually all long-term QF power purchase agreements were signed in the late 1980s as a result of the Public Utility Regulatory Policies Act of 1978. These contracts have terms that extend in many cases well beyond ten years from now, and thus the effect of collapsing the recovery of stranded costs associated with such agreements into a ten-year period is far more dramatic than forcing a similar recovery period for stranded costs associated with older, more fully depreciated utility generating assets.
- Unlike utility "regulatory assets," the utilities' obligations under most power purchase agreements are easily defined, easily compared to market rates, and easily monitored. Providing for recovery of stranded costs associated with such agreements beyond ten years thus poses far fewer regulatory difficulties than

recovery of stranded costs associated with regulatory assets, which are much more susceptible to manipulation.

- If stranded cost charges may be collected only in years 1-10, but are applicable to costs to be incurred beyond year 10, utilities will be able to accumulate a unique capital source -- a "stranded cost fund" -- that they are likely to exploit. While escrowing or otherwise segregating such a fund from other utility revenues might alleviate this problem, such a fund would be subject to the claims of other creditors of the utilities. In the event of a utility bankruptcy, funds recovered supposedly to pay the above-market costs associated with power purchase agreements and other stranded costs could be considered property of the entire estate of the bankrupt utility. Adoption of the proposed amendment allowing recovery of stranded costs associated with long-term contracts to parallel the term of the contract would sharply reduce accumulated stranded cost changes, and thus avoid the need for regulation of stranded cost funds.

- Other major jurisdictions that have considered the stranded cost issue have opted to permit recovery of stranded costs associated with long-term power purchase agreements over the life of the affected contract. Massachusetts utilities should not be treated any differently in this respect from their future out-of-

state competitors.

For all of these reasons, IEC proposes the amendments to the Proposed Rules that are set forth in Appendix B hereto. These amendments recognize the need to spread recovery of stranded costs associated with power purchase agreements over their actual life, so as to give the Department the greatest chance of providing near-term rate relief and to avoid the need for regulation of accumulated stranded cost charges.

III. THE PROPOSED RULES PROVIDE INSUFFICIENT INCENTIVES FOR THE USE OF CLEANER TECHNOLOGIES

In D.P.U. 95-30, one of the Department's key restructuring principles was to support and further the goals of environmental regulation. While the Department's comments to its Proposed Rules speak to environmental concerns, the Proposed Rules themselves are largely silent about the environment. The Proposed Rules provide incentives for increased environmental protection only for Renewable Energy Resources (see Proposed § 11.08) and Demand-side Management programs (see Proposed § 11.09). Environmental concerns do not appear anywhere else in the Proposed Rules.

It bears repeating that environmental regulation must actually and affirmatively be furthered during restructuring. The Department's current proposals (or, more precisely, the absence of such proposals) ignore two fundamental facts: (1) the introduction of independent power facilities in New England over

the last decade has enabled the region to reduce overall emissions associated with producing electricity; and (2) if solely left to market forces, the environment may be degraded. If, for example, the Massachusetts electric generation market is opened to virtually any company that wishes to sell power -- even if it is "dirty" power -- cleaner generators are likely to be the losers.

As IEC stressed in its comments filed in this proceeding on April 12, 1996, requiring competitors in the generation market to meet common environmental standards clearly would promote economic efficiency as well as environmental improvement. Modern generating plants, including those built by IEC, have been constructed in an era of greater environmental concern and under much more stringent standards than those that continue to be applied to older and less efficient fossil fuel plants. Indeed, many such plants have been grandfathered from recent, stricter environmental standards. As a result, there are pervasive, significant differences between the environmental impacts of modern gas-fired generation facilities, such as those built by IEC, and oil and coal generating units, especially those built more than a decade ago.[6] Power from older plants is thus deceptively "cheap" because it externalizes the costs of increased pollution, which are paid by everyone in the form of a degraded environment and the associated health and other costs.

[6] IEC describes these differences in detail at pages 4-6 of its April 12, 1996 comments in this proceeding.

If economic efficiency -- rather than cost shifting -- is an important objective, and if environmental progress is to continue, all market competitors should be encouraged (if not forced) to internalize more of the costs of pollution. Without such internalization, restructuring of the electric industry will result in stranding the benefits associated with investments in cleaner technologies, and yield artificially low prices for electricity at the expense of the environment.

While the Department's powers to manage environmental problems may be limited, the Department can do much more than it has done in the Proposed Rules. To create greater incentives for the use of cleaner generation, IEC proposes that the Department amend its proposed stranded cost recovery rules to remove their unfair disadvantage for "greener" producers.[7] These incentives should come in two forms:

First, electric utilities should be allowed to return to ratepayers what are essentially "stranded benefits" through an incentive mechanism within the Department's proposed Stranded Cost Access Charge. IEC proposes an additional period of recovery, perhaps two years, for stranded costs associated with low-emission generating assets owned by utilities (or, in the case of power purchase agreements involving low-emission generating facilities, the term of the power purchase agreement).

[7] Alternative regulations embodying these environmental principles are found in Appendix C hereto.

IEC would define a "low-emission" facility as any electrical generating unit which has a heat input equal to or greater than 250 million BTU per hour and that, on or before two years from the date of Department's final rules in this proceeding, [8] (1) has emissions of nitrogen oxide at or below 0.15 pounds per million BTU of heat input on a 30-day rolling average and (2) has emissions of sulfur dioxide at or below 0.2 pounds per million BTU of heat input on a 30-day rolling average. Utilities could bring such facilities into compliance by adopting or implementing any of the following approaches, either exclusively or in combination: pollution control technologies, fuel switching, state or federally authorized emissions trading, and repowering.[9]

IEC's second proposed incentive is to amend the stranded cost recovery regulations to encourage electric utilities with affiliated generation to make good business decisions about whether to continue to operate their power plants or to shut them down when they are uneconomic in the competitive generation market. The Department should no longer apply the "used and useful" principle to power plants with stranded costs if prudent business and environmental practices indicate that such plants should be shut down. IEC's proposed amendments thus make clear that a utility need not operate a high-emission facility solely

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[8] In Appendix C, IEC uses January 1, 1999 only as a proxy for the two-year anniversary of the Department's final rules in this proceeding.

[9] IEC does not propose amending Proposed § 11.03(2)'s definition of "Embedded Costs." Thus, consistent with the Department's comments to the Proposed Rules (see page 38 and note 26), utilities would not be able to recover as stranded costs those expenses incurred after August 16, 1995, even if a utility incurred those costs solely for the purpose of meeting the environmental standards proposed in Appendix C.

in order to collect stranded costs associated with the facility, or to demonstrate that it is mitigating such stranded costs.

The amendments proposed by IEC are appropriate for the simple reason that the "stranded benefits" of "greener" generation sources -- regardless of whether they are powered by gas, water or nuclear energy -- should and must be considered together with, and not separate from, "stranded costs." IEC's proposed amendments permit utilities and their ratepayers to realize the true value of these stranded benefits over the life of the facility or contract. Use of the Stranded Cost Access Charge to provide an incentive for the use of cleaner generation also should eliminate the Department's concerns over its jurisdiction to support environmental improvements. The methods of identifying, calculating and collecting stranded cost charges are unquestionably within the Department's jurisdiction. Using the charge to further environmental progress also avoids the problem identified in Massachusetts Electric Company v. Department of Public Utilities, 419 Mass. 239 (1994). There the court held that the Department lacked the power to force utilities within its jurisdiction to consider certain market externalities. By contrast, a rate recovery incentive mechanism that captures stranded benefits merely regulates the revenues and returns of the utilities within the Department's jurisdiction for assets that required Department approval to be acquired in the first place. The incentives proposed by IEC are a necessary adjustment to the Stranded Cost Access Charge to avoid distorting

the market in favor of "dirty" generation. This Department should approve such incentives in its final rules.

CONCLUSION

The Department should adopt IEC's proposed regulations as set forth in Appendices A-C hereto.

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APPENDIX A

IEC Competitive Market Transition Rules

In order to ensure that a competitive electric generation market exists before retail choice begins and utilities begin collecting stranded costs, IEC presents the following alternatives to the Proposed Rules:

1Section 11.03 should be amended as follows:

1 Replace the dates "2007" in the final sentences of §§ 11.03(3)(a)(iii)(5) and (6) with "2012."

Comment: *Since it is not certain that the prerequisites for a competitive electric generation market will exist as of January 1, 1998, the utilities should file Mitigation projections that permit stranded cost recovery to begin as soon as the prerequisites are achieved. Forecasts through the year 2012 should give the utilities sufficient leeway, assuming that the prerequisites can be met before January 1, 2003.*

2 Replace the date "2007" in § 11.03(3)(a)(iv)(4) with "2012."

Comment: *See comment for (1)(a) above.*

3 Replace § 11.03(3)(a)(v)(1) in its entirety with: "Beginning on the Collection Commencement Date, as hereinafter defined, the company may begin to recover the level of Stranded Costs approved by the Department through the Stranded Cost Access Charge. The Collection Commencement Date shall be that date which is 90 days after (A) the Department determines that an Independent System Operator has been established, (B) the effective date of FERC-approved, unappealable open access tariffs applicable to all Transmission within the Commonwealth of Massachusetts; and (C) the Department determines that horizontal and/or vertical market power is not likely to exist in the relevant market for generation in Massachusetts upon commencement of retail competition at a level that harms competition."

Comment: *This alternative regulation insures that three of the four conditions necessary for a competitive generation market exist before retail competition begins and utilities begin collecting the Stranded Cost Access Charge. The fourth condition, environmental comparability, is addressed in Appendix C.*

4 Replace "on December 31, 2007" in § 11.03(3)(a)(v)(4) with "ten years after the Collection Commencement Date".

Comment: *This change continues the ten-year stranded cost recovery period found in the Proposed Rules, but ties the term of the period directly to the date by which the Department would have found the existence of the four preconditions for a competitive generation market.*

5 Replace "the date upon which the Stranded Cost Charge is implemented" in § 11.03(a)(v)(4)(3) with "the Collection Commencement Date".

Comment: *This amendment conforms the Department's "bandwidth" proposal to the other amendments discussed above.*

2To § 11.07(2), the following new § 11.07(2)(h) should be added: "(h) A certification that the Supplier has appointed an agent for service of process within the Commonwealth of Massachusetts."

Comment: *This amendment aims to insure that all potential providers of Generation Service are amenable to suit in the Commonwealth.*

3At the end of § 11.05(9)(a)(1), and at the end of the first sentence of § 11.05(9)(b), insert the words ", on and after the Collection Commencement Date."

Comment: *These amendments tie the beginning of retail choice to the existence of the preconditions for a competitive generation market.*

4Sections 11.03(2), 11.03(3)(a)(v)(4), and 11.03(4)(3) should be amended as set forth in Appendix C.

Comment: *The amendments proposed in Appendix C help ensure the existence of the fourth condition for a competitive market, environmental comparability.*

APPENDIX B

IEC Life-of-Asset Collection Rules

In order to maximize the possibility that restructuring will result in near-term rate relief, and that Stranded Cost Access Charges will not have to be escrowed, IEC presents the following amendments to Proposed § 11.03:

1. Replace the words "between January 1, 1998 and December 31, 2007" in the final sentence of § 11.03(3)(a)(iii)(6) with "beginning January 1, 1998 through the end of the term of each power purchase agreement".

   Comment: *See part (II) of IEC's initial comments on Proposed Rules.*

2. After the words "attributable to" in § 11.03(3)(a)(iv)(4) insert the words "power purchase agreements and".

   Comment: *See part (II) of IEC's initial comments on Proposed Rules.*

3. Insert after § 11.03(3)(a)(iv)(4) the following new § 11.03(3)(a)(iv)(5): "For Stranded Costs associated with power purchase agreements, the company shall present estimates of Stranded Costs in terms of (a) total dollars, and (b) cents-per-kilowatt hour, per each year for the term of the company's purchase obligations under each agreement. The company shall summarize the method and assumptions used in the cent-per-kilowatt hour calculation."

   Comment: *See part (II) of IEC's initial comments on Proposed Rules.*

4. Renumber Proposed § 11.03(3)(a)(iv)(5) as § 11.03(3)(a)(iv)(6).

   Comment: *See Amendment (3) above.*

5. After the words "with the exception of" in § 11.03(3)(a)(v)(4), insert "power purchase contract obligations and"; and after the first sentence in the same section, insert "Power purchase contract obligations shall be collected in each year, for each contract, until the term of said contract expires."

   Comment: *See part (II) of IEC's initial comments on Proposed Rules.*

6. After "the Stranded Cost Access Charge is implemented," in

§ 11.03(4)(3), insert "and every five years thereafter until a company is no longer permitted to collect its applicable Stranded Cost Access Charge,".

Comment: *This amendment conforms the Department's "bandwidth" proposal to the other amendments discussed above.*

APPENDIX C

IEC Environmental Incentive Rules

In order to provide incentives for use of electricity from low-emission generation sources, IEC presents the following alternatives to the Proposed Rules:

1. The first sentence of § 11.03(3)(a)(v)(4) should be amended to read as follows: "The company's collection of Stranded Costs shall end on December 31, 2007, for all categories of Embedded Costs, with the exception of (a) all Embedded Costs associated with any electrical generating unit that has a heat input equal to or greater than 250 million BTU per hour and which, on and after January 1, 1999, has (1) emissions of nitrogen oxide that do not exceed 0.15 pounds per million BTU of heat input on a 30-day rolling average; and (2) has emissions of sulfur dioxide that do not exceed 0.2 pounds per million BTU of heat input on a 30-day rolling average; and (b) nuclear decommissioning costs." ; and at the end of § 11.03(3)(a)(v)(4), insert: "For any electrical generating unit or plant associated with long-term power purchase agreements that meet the standards set forth in (a) above the Embedded Costs of such assets or agreements may be collected up until the end of the depreciable life of the Unit or the term of the contract, as applicable. Before June 30, 1997, the Department shall issue regulations allowing the owners of electrical generating units or those electric utilities that contract with the owners of electrical generating units to meet the requirements of this section by adopting or implementing any of the following approaches, either exclusively or in combination: pollution control technologies, plant closings, fuel switching, state or federally authorized emissions trading, and repowering. For purposes of this section, the term 'electrical generating unit' means any steam electric generating unit that is constructed for the purposes of supplying more than one-third of its potential electric output capacity and more than 25 MW electrical output to any utility power distribution system for sale. Any steam supplied to a steam distribution system for the purpose of providing steam to a steam-electric generator that would produce an electrical energy for sale is also considered in determining electrical energy output capacity of the affected facility."

Comment: *This amendment provides an incentive to the operators of low-emission electrical generating units in the form of an extended stranded cost recovery period. See part (III) of IEC's initial comments.*

2. After the words "the Stranded Costs Access Charges implemented" in § 11.03(4)(3), insert the words "and every five years thereafter until a company is no longer permitted to

collect its applicable Stranded Costs Access Charge,".

Comment: *This amendment conforms the Department's "bandwidth" proposal to the other amendments discussed above.*